The Companies Act 2006: auditor liability

The legal and regulatory framework governing the audit market has been the subject of intense scrutiny in recent times. The issue of auditor liability in particular has been a hot topic world wide since the collapse of Arthur Andersen. Here we look at new UK rules allowing auditors to limit their liability. We also address some other noteworthy legal changes affecting auditors in the UK.

Other countries

Several EU member states including Germany already have statutory limits on auditor liability. The EU Commission is consulting on whether to introduce pan-European rules on the issue. Caps on auditor liability are not currently permitted in the US but earlier this year the US Treasury announced a review of financial reporting which will also examine the audit profession and the question of limitations on auditor liability in the US.

New UK rules

In the UK, the Government was initially unsympathetic to calls for auditors to be able to limit their liability. However, the Companies Act 2006 (**"Act"**) will allow them to do so by agreement with the company. The new rules come into force on 6 April 2008.

The Act repeats the existing prohibition on a company indemnifying its own auditors or exempting them from liability for audits. This is subject to a new exception which allows companies and their auditors to enter so-called liability limitation agreements to limit the auditor's liability to the company in respect of any negligence, default, breach of duty or breach of trust occurring in the course of an audit.

The agreement must relate to the audit of a specified financial year (so it will have to be renewed annually) and it must be approved by members (shareholders of a private company may waive this requirement). Current legislation allows companies to grant indemnities to auditors for the costs of successfully defending proceedings and this will continue but the existing carve out which allows companies to purchase insurance for their auditors will not.

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How will limitation liability agreements work?

The Financial Reporting Council has established an independent working group to produce guidance on the use of liability limitation agreements including the form they will take. The most likely approach will be to fix a limit on liability by reference to a specified amount or a formula (e.g. a multiple of fees) or to agree proportionate liability i.e. that the auditor is only liable to the extent it is responsible for the damage suffered.

The Government's aim is to enhance the competitiveness of the audit sector, currently hugely dominated by the Big Four accountancy firms. A recent report found that the Big Four audit all but one of the FTSE 100 companies and represent 99% of audit fees in the FTSE 350. One reason to allow audit firms to limit their liability is to ensure the Big Four (once the Big Six) do not become the Big Three or worse. But the other reason is to try to reduce barriers to entry for other audit firms to allow them to compete for the big ticket audit work (but where the risk of liability is all the higher). Being able to agree proportionate liability may encourage those smaller players to enter the higher end of the audit market. However, given that the Big Four could equally decide to negotiate specific, but relatively high, caps on liability, this could dissuade other entrants to the market who are unable to match those high caps. For this reason, the Government inserted a provision in the Act at a late stage to allow it to make regulations to dictate what can and cannot be agreed should any undesirable practices develop.

The other safeguard is in the Act itself which provides that liability limitation agreements will not be effective if they would result in the company recovering an amount that was less than what is fair and reasonable having regard to the auditor's responsibilities under the Act, the professional standards expected of it and the nature and purpose of its contractual obligations to the company. If an agreement purports to limit liability to less than a fair and reasonable amount, the courts will be able to substitute whatever is fair and reasonable. It remains to be seen what the courts will make of this provision as it is only a matter of time until they are asked to opine.

The Secretary of State may make regulations requiring companies to disclose details of liability limitation agreements. The Government currently intends to address this by way of a note to the accounts.

It remains to be seen what auditors are able to agree with directors and what approach will be most palatable to shareholders, who may be more amenable to a proportionate liability rather than fixed cap approach.

New criminal offence for inaccurate auditors' reports

A new criminal offence, punishable by fine, will be committed by any person eligible to be a statutory auditor who knowingly or recklessly causes an auditor's report on a company's annual accounts to include anything that is materially misleading, false or deceptive or to omit a statement required by the Act outlining a problem with the accounts. Where the auditor is a firm, the offence applies to any director, member, employee or agent of the firm who is eligible for appointment as an auditor of the company. The offence will apply to financial years starting on or after 6 April 2008.

The words "knowingly or recklessly" were hotly debated during the Act's passage through parliament and, in particular, the question of what is "reckless" in this context. The Government considers that whilst a reckless auditor is unlikely to be acting honestly, dishonesty should not

be a prerequisite for the offence. The test for recklessness is subjective, requiring knowledge that an act or failure to act carries unreasonable risks and a conscious decision by the auditor to go ahead despite this. The Secretary of State may issue guidance for the courts on how to prosecute the offence. The Government has announced that this guidance will be in place by April 2008 and that prosecution (as opposed to disciplinary proceedings) should only be used in the most serious cases where there is specific evidence of recklessness (excluding any inference of recklessness from hindsight).

The creation of this new offence may lead to the audit profession becoming more risk averse with consequences for audit costs.

Including auditor's name in report

Under new rules in force on 6 April 2008, an auditor's report must state the name of the auditor and (where the auditor is a firm) of the senior statutory auditor. The senior statutory auditor is the individual identified by the firm as such in relation to the audit in accordance with prescribed standards. Responsibility for compliance falls on the company and its officers.

An exception has, however, been introduced to deal with threats from extremist groups. Auditors will be able to take advantage of a provision in the Act that will allow companies to pass a shareholders' resolution each year to the effect that the auditor's name and the name of the senior statutory auditor should not be revealed in publicly available copies of the accounts, if the company considers on reasonable grounds that disclosure of the name would or is likely to create a serious risk of violence against or intimidation of those persons.

Signing the audit report

Where the auditor is a firm, new rules also in force on 6 April 2008 will require the senior statutory auditor to sign the audit report in his or her own name, for and on behalf of the firm. The current practice is for the senior auditor to sign in the name of his or her firm. For the individuals concerned, having to put their names to a public document may be more of an issue of reputation. In pure liability terms, the Act says the senior statutory auditor will not be exposed to any additional civil liability by having signed the audit report.

Key provisions

Limitations on auditor liability: ss532-538 Companies Act 2006.
Liability for inaccurate auditor's report: s507 Companies Act 2006.
Omitting auditor's name from report: ss505-506 Companies Act 2006.
Signing the audit report: s503 Companies Act 2006.

- **If you have any questions or require specific advice on any matter discussed in this publication, please contact Annabel Evans (DDI: +44(0)2077828858 or E-mail aevans@mayerbrown.com) or your regular contact at Mayer Brown.**

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